

**Procedures for Granting Installment
Agreements to Self-Employed Taxpayers Can
Be Improved**

September 2003

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 16, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report - Procedures for Granting Installment
Agreements to Self-Employed Taxpayers Can Be Improved
(Audit # 200230040)

This report presents the results of our review of the Internal Revenue Service's (IRS) procedures for granting Installment Agreements (IA) to self-employed taxpayers. The overall objectives of this review were to determine whether IAs granted to self-employed taxpayers were proper and whether taxpayers were continuing to remain compliant and pay estimated taxes if required.

Through April 2003, there were approximately \$2.3 billion in outstanding IAs for all individual and business taxpayers, about \$1.8 billion of which had been granted by the Automated Collection System (ACS)¹ function.

In summary, our review of 57 IAs granted by the Collection Field function (CFf)² showed that employees performed adequate financial analyses when determining the taxpayers' abilities to make monthly payments, and managers properly approved IAs. However, improvement is needed in the ACS function when granting IAs. Our review of 56 IAs granted by the ACS function showed that employees did not perform sufficient financial analysis in 31 cases (55 percent), and managers did not document approval of the IAs in 41 cases (73 percent). Without adequate financial analysis and managerial approval,

¹ The ACS is a telephone contact system where telephone assistants collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

² The CFf is the unit in the Area Offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled returns.

taxpayers can misstate expenses and income and not pay an appropriate monthly amount for the IA.

Also, we determined that taxpayers were not always current in paying estimated taxes when they were granted IAs. Of 113 taxpayers in our sample, 87 were required to pay estimated taxes, but 37 (43 percent) of the 87 were not current with estimated taxes. IRS guidelines and interpretation among managers are not consistent with regard to granting IAs when estimated taxes are due from taxpayers. Inconsistent guidelines make it difficult for employees to know the correct procedures to use and can result in inconsistent treatment of taxpayers when their attempts to obtain IAs are accepted or rejected. If taxpayers have not paid required estimated taxes at the time they request an IA, they will potentially owe additional taxes and be in the same situation that led them to need an IA.

Finally, we reviewed a sample of 67 IAs granted in Calendar Year 2001 to track taxpayers' subsequent compliance with paying estimated taxes and to determine whether the IRS should pursue legislation to terminate IAs if taxpayers do not remain compliant. Our results showed that there was insufficient support to recommend that the IRS pursue legislation for terminating IAs when self-employed taxpayers do not make estimated payments.

We recommended that the Director, Compliance, Small Business/Self-Employed (SB/SE) Division, implement a systemic control in the ACS that would automatically route an IA over \$25,000 to a manager for approval, reemphasize procedures and requirements to ACS employees for granting IAs, and for certain situations, reevaluate and make consistent procedures for granting IAs when estimated taxes are due from the taxpayers.

Management's Response: The Commissioner, SB/SE Division, agreed with our recommendations. SB/SE Division management plans to request a systemic control in ACS that would automatically route all IA cases over \$25,000 to a manager for approval. In addition, management will issue a memorandum of instructions to employees and managers reminding them of the substantiation required for financial analysis and the criteria for streamlined agreements, and instruct managers to cover financial analysis in group meetings. Finally, SB/SE Division management will amend appropriate sections of the Internal Revenue Manual to ensure consistency in the procedures for granting IAs. The Commissioner, SB/SE Division, did not agree with all the outcome measures reported; however, we believe that the rationale used for estimating potential Federal taxes due from the taxpayers is valid. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

**Procedures for Granting Installment Agreements
to Self-Employed Taxpayers Can Be Improved**

Table of Contents

Background	Page 1
Collection Field Function Employees Properly Analyzed Financial Information	Page 2
Automated Collection System Function Employees Did Not Properly Analyze Financial Information	Page 2
<u>Recommendations 1 and 2:</u>	Page 4
Taxpayers Were Not Always Current in Paying Estimated Taxes When Employees Granted Installment Agreements	Page 4
<u>Recommendation 3:</u>	Page 6
The Number of Taxpayers Not Paying Estimated Taxes After Receiving Installment Agreements Was Not Significant	Page 7
Appendix I – Detailed Objectives, Scope, and Methodology	Page 10
Appendix II – Major Contributors to This Report.....	Page 13
Appendix III – Report Distribution List	Page 14
Appendix IV – Outcome Measures	Page 15
Appendix V – Internal Revenue Manual Sections Related to Estimated Tax Compliance When Granting Installment Agreements	Page 16
Appendix VI – Management’s Response to the Draft Report	Page 18

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

Background

The Internal Revenue Service (IRS) expects taxpayers to pay the full amount of taxes owed when they file their tax returns. However, the IRS allows taxpayers to pay their taxes in installments, with interest and penalty, when full payment is not possible. IRS procedures allow taxpayers to enter into Installment Agreements (IA) any time during the collection process. Only IAs that provide for full payment of liabilities may be granted. After an IA is granted, taxpayers must remain current with the payment requirements of the IA.

As of the end of April 2003, the IRS had about 251,000 outstanding IAs, totaling approximately \$2.3 billion. These IAs had been granted through the Collection Field function (CFf)¹ (14,086 totaling approximately \$497 million) and the Automated Collection System (ACS)² function (237,356 totaling approximately \$1.8 billion). These figures include both individual and business taxpayers.

When granting an IA, CFf and ACS employees must properly analyze the taxpayer's financial information to determine the taxpayer's ability to make monthly payments. Delinquent tax payments and taxpayer defaults on IAs may result if the taxpayer's financial information is not properly analyzed.

Decisions for granting IAs to self-employed taxpayers are more complex than those for taxpayers who work for wages because verifying their incomes is more difficult. In addition, self-employed taxpayers usually are required to make periodic estimated tax payments since they do not have withholdings on their income, as wage earners do. As of the end of August 2002, approximately 169,000 IAs totaling about \$702 million had been granted to self-employed taxpayers. Of these, 3,039 had outstanding

¹ The CFf is the unit in the area offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled returns.

² The ACS is a telephone contact system where telephone assistors collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

IAs with liabilities over \$25,000, totaling about \$150 million.

Taxpayers with individual tax liabilities (aggregate unpaid balances including assessed taxes, interest, and penalties) over \$25,000 need to provide detailed financial information to the IRS. In addition, IAs over \$25,000 require managerial approval. Because of these additional risks, our review was limited to self-employed taxpayers who were granted IAs greater than \$25,000.

We conducted the audit from October 2002 to June 2003 in the Philadelphia, Pennsylvania, and Nashville, Tennessee, ACS sites and the Compliance Field Areas 3 (Pennsylvania, New Jersey) and 5 (Florida). The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Collection Field Function Employees Properly Analyzed Financial Information

Our judgmental sample review of 57 IAs granted by the CFF showed that employees performed adequate financial analyses of taxpayers' abilities to make monthly payments by evaluating and verifying the taxpayers' income and expenses. CFF employees allowed taxpayers to claim only the allowable standard expense amounts³ when applicable. Also, we determined that employees were being flexible when applying the standard expense amounts. For example, following current IRS procedures, employees allowed all reasonable expenses if taxpayers were paying off their Federal tax liabilities within 60 months. Finally, managers properly approved the IAs.

Automated Collection System Function Employees Did Not Properly Analyze Financial Information

IRS procedures state that employees must obtain and analyze detailed financial information from taxpayers to determine their ability to make monthly payments for IAs over \$25,000. ACS function procedures require employees to allow the taxpayers to only claim the standard expense amounts unless the taxpayers provide adequate substantiation for additional expenses. In those situations,

³ There are national and local standard amounts for expenses taxpayers can claim such as food, housekeeping supplies, apparel and services, personal care, housing, utilities, and transportation.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

the employees should document the case history. If taxpayers can pay off their Federal tax liabilities within 60 months, substantiation is not required. Procedures also require employees to document reasons for taxpayers' income amounts that are significantly different on their financial statement and their last filed income tax return. Managers are required to approve IAs over \$25,000.

Our judgmental sample review of 56 cases showed that ACS employees were not properly analyzing financial information. In 31 (55 percent) of the 56 sampled cases, the case history either did not include any financial information, or differences in income and expenses allowed over the standard were not explained. A summary of the 56 cases follows:

- In 17 cases, there was no evidence that financial information was obtained.
- In 14 cases, no documentation existed explaining why expenses claimed by the taxpayer were more than the standard amounts, or the income differences were significant.
- In 25 cases, financial information was properly obtained and analyzed.

Additionally, managers did not document approval of the IAs in 41 (73 percent) of the 56 cases.

One factor potentially contributing to these conditions is that employees may be confused regarding the requirements for processing IAs as streamlined agreements. We determined that in many cases, employees coded cases incorrectly, indicating that the cases were streamlined agreements. Streamlined processing should only be used for IAs with an unpaid balance of \$25,000 or less. Detailed financial information and manager approval are not required for streamlined agreements. If employees thought these were streamlined agreements, it may have been the primary cause for not performing the financial analysis and obtaining managerial approval.

When IAs are granted without sufficient financial analysis and verification of income and expenses, the potential exists

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

for taxpayers to understate expenses and/or show more income than is available and, therefore, be unable to make the monthly payments. This would result in additional staff resources needed to be used by the IRS to later collect the liabilities. Conversely, the taxpayer could have overstated expenses and/or shown less income and, therefore, possibly paid more each month, resulting in a quicker payoff of the liabilities.

Recommendations

The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, who is responsible for implementing policies for the Collection function, should:

1. Consider implementing a systemic control in ACS that would automatically route an IA case over \$25,000 to a manager for approval.

Management's response: SB/SE Division management will prepare a Request for Information Services, through the Office of Compliance Center Collection, to implement a systemic control in ACS to route all IA cases over \$25,000 to a manager for approval.

2. Reemphasize procedures to employees and managers regarding substantiation required for financial analysis and criteria for streamlined agreements.

Management's response: SB/SE Division management will issue a memorandum of instructions to employees and managers reminding them of the substantiation required for financial analysis and the criteria for streamlined agreements. Managers will also be instructed to cover financial analysis in group meetings.

Taxpayers Were Not Always Current in Paying Estimated Taxes When Employees Granted Installment Agreements

Estimated taxes are periodic payments made by individuals who do not have sufficient Federal taxes withheld and/or have other income, such as self-employment income. Estimated taxes should be considered as an expense when determining a taxpayer's monthly payments for an IA. Also, to prevent the delinquency situation from occurring again, a taxpayer should be paying estimated taxes for the

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

current year and continue to pay estimated taxes on subsequent tax liabilities.

The IRS procedure for working Collection cases is to bring taxpayers into compliance with filing current returns and making current Federal tax deposits and estimated taxes before addressing taxes that are already owed. An IA is a way to address tax liabilities already owed. The procedures for determining whether to grant an IA to a taxpayer who is not current in paying estimated taxes are confusing and are located throughout various sections of the Internal Revenue Manual (IRM). For example, the wording in one section states that taxpayers should be current from the date of the IA and forward. However, another section related to rejecting a proposed IA states an IA should be rejected if the taxpayer has not paid estimated taxes for the current tax quarter. SB/SE Division Compliance function managers informed us that they are revising the procedures to be more consistent. See Appendix V for examples of other IRS procedures that relate to this topic. Inconsistent guidelines make it difficult for employees to know the correct procedures to use and can result in inconsistent treatment of taxpayers when their attempts to obtain IAs are accepted or rejected.

Our review of 113 IAs (57 closed by the CFF and 56 closed by the ACS function) showed that 87 taxpayers were required to pay estimated taxes. Of those 87 taxpayers, 37 (43 percent) were not current in paying their estimated taxes when the IRS granted them IAs. We considered taxpayers not current if they had not made estimated tax payments as required in the current year. Some taxpayers in our sample received an IA in early 2003, when 2003 estimated taxes were not yet due; we considered them not current if they had not paid estimated taxes for the prior year.

Our interpretation of whether a taxpayer was current in paying his or her estimated taxes differs from those used by IRS management, which also vary among individual offices. Managers in two offices informed us they expect employees to determine if taxpayers are in compliance with estimated taxes for the current quarter. Other management officials

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

informed us that taxpayers must be current with estimated taxes from the IA date and forward, and current compliance is not a condition of granting IAs.

Taxpayers who do not pay estimated taxes could owe additional taxes and be in the same situation that led them to need an IA in the first place. If the 37 self-employed taxpayers in our sample do not pay (or have not paid) estimated taxes, they will potentially owe taxes for Tax Year (TY) 2002. We determined that for those 10 taxpayers who had filed TY 2002 returns, there is currently approximately \$123,000 owed in taxes. Based on their most recently filed returns, we estimate that the 27 taxpayers who had not yet filed TY 2002 returns will owe approximately \$590,000, if they do not include payment when the returns are filed.

Recommendation

3. The Director, Compliance, SB/SE Division, should ensure IRS procedures are consistent for granting IAs where estimated taxes are involved and reevaluate those procedures for certain situations to require that taxpayers be current with the payment of all estimated taxes when an IA is granted.

Management's Response: SB/SE Division management will amend IRM sections 5.14 and 5.19 to ensure consistency in the procedures for granting an IA. Management will reevaluate IA procedures for opportunities to further encourage compliance with the payment of all estimated taxes when an IA is granted. An interim guidance memorandum will be issued to the field explaining the changes by December 31, 2003.

Office of Audit Comment: Although SB/SE Division management agreed with the recommendation, management did not agree with the outcome measure that potentially \$713,000 in revenue would be lost due to unpaid estimated tax payments. For 27 of 37 taxpayers, we used the taxpayers' prior Federal tax liabilities to estimate \$590,000 of the \$713,000 outcome measure. SB/SE Division management stated that a prior year's tax liability is not a

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

conclusive predictor of current year income or ultimate tax liability. The estimated amount of tax liability may not have materialized in TY 2002 because self-employed taxpayer incomes can and do fluctuate. Unless the returns are reviewed, it cannot be determined if the total tax consists of self-employed income only.

We agree that the outcome measure is not an exact amount. Our estimate is based on the last known filed tax return of the taxpayers, and we think this is the best available information to estimate potential Federal taxes due from the taxpayers. The amount of taxes due when the return is filed could be less, but it could also be more.

The Number of Taxpayers Not Paying Estimated Taxes After Receiving Installment Agreements Was Not Significant

To maximize revenue received by the Federal Government and to minimize the use of IRS resources, taxpayers should continue to pay estimated taxes on their potential subsequent tax liabilities to prevent a delinquency situation from occurring again. However, there is no requirement for the IRS to monitor whether taxpayers stay current in paying estimated taxes after an IA is granted. Nor, according to an IRS Counsel opinion, can the IRS default an IA if the taxpayer does not pay estimated taxes. The IRS also cannot default the IA if the taxpayer does not file a return. The IRS can default an IA when a taxpayer files a tax return and incurs an additional tax liability but does not pay, or when a taxpayer does not make the IA payments.

The Department of the Treasury requested legislative changes in 2003 that would allow for the termination of IAs when taxpayers fail to file tax returns or fail to make Federal tax deposits on employment tax returns (business taxpayers). However, the request did not provide for the termination of IAs when taxpayers failed to make estimated tax payments (individual taxpayers).

Since individual taxpayers represent 83 percent (\$1.9 billion of \$2.3 billion) of the total dollars in IA status as of April 2003, we attempted to determine whether similar legislation might be appropriate for terminating IAs when estimated tax payments are not made. We attempted to identify the rate at which taxpayers pay their estimated taxes after receiving an IA and the volume of IAs in which estimated payments might be applicable.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

Our review of 67 statistically sampled IAs granted between January and December 2001 showed that 39 taxpayers are currently required to pay estimated taxes due to business income.⁴ The other 28 taxpayers had withholdings that appeared sufficient to fully pay their tax liabilities. Of these 39 taxpayers:

- Fourteen filed subsequent returns and incurred additional liabilities.
- Six did not file a return.
- Five did not have a return due.
- Seven filed a subsequent return and fully paid the account.

In summary, 20 (30 percent) of the 67 taxpayers are not current in their filing and/or paying of taxes, resulting in additional taxes owed to the Federal Government. Another 5 could become delinquent when their returns are due, resulting in 37 percent of the cases causing additional work for the IRS.

Although this is a relatively high percentage, it should be noted that we selected our sample from all of the 760 self-employed taxpayers with IAs granted in Calendar Year (CY) 2001 having tax liabilities greater than \$25,000. We do not consider this a significant number of taxpayers when compared to the overall population of 169,000 taxpayers in IA status as of August 2002. (It should be noted that there were another 2,279 self-employed taxpayers with liabilities greater than \$25,000 also in IA status as of August 2002, but their IA was granted in a year other than CY 2001, and we only included those granted in CY 2001).

In addition, approximately 166,000 of the 169,000 self-employed taxpayers had IAs with liabilities of \$25,000 or less as of August 2002. Many of these had liabilities for which estimated tax payments are not required or amounts would be minimal. Estimated tax amount

⁴ Our sample was selected from taxpayers in IA status as of August 2002.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

requirements are based on specific tax periods.⁵ The 169,000 self-employed taxpayers with IAs included about 315,000 tax periods. Of those 315,000 tax periods:

- Approximately 113,000 (36 percent) were for liabilities less than \$1,000 per year; therefore, no estimated tax payments are necessary.
- Approximately 134,000 (43 percent) had liabilities between \$1,000 and \$5,000, resulting in quarterly estimated payments of only \$1,250 or less.⁶

As a result of our tests, we are not recommending at this time that the IRS pursue legislation for terminating IAs when self-employed taxpayers do not make estimated tax payments. IRS management analyzed similar information over the past few years and determined that the return on investment would be marginal. Our results did not show any reason to override that conclusion. The additional costs for the IRS to default these agreements do not seem to justify the limited non-compliance in these situations.

⁵ A tax period for an individual is a calendar year for which a tax return is due.

⁶ Withholding could be sufficient if the spouse had sufficient withholding or the taxpayer had an additional job as a wage earner.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be improved

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to determine whether Installment Agreements (IA) granted to self-employed taxpayers were proper and whether taxpayers were continuing to remain compliant and pay estimated taxes if required. We conducted the following tests to accomplish the objectives:

- I. Determined whether the Internal Revenue Service (IRS) has effective procedures to ensure IAs granted to self-employed taxpayers were appropriate and the process and procedures were consistently applied.
 - A. Obtained guidelines and procedures established for IAs in both the Automated Collection System (ACS)¹ and the Collection Field functions (CFf).² We specifically researched guidelines for financial analysis and compliance with estimated tax payments.
 - B. From the Integrated Data Retrieval System (IDRS),³ requested data on self-employed individual taxpayers with outstanding IAs as of August 2002 that were processed by the ACS or CFf. We performed the following analyses of the data:
 1. Identified a population of 169,169 self-employed individual taxpayers.
 2. Validated the data by verifying taxpayer information and liabilities on the IDRS for selected taxpayers.
 3. From the population, identified 3,039 IAs with over \$25,000 in tax liabilities granted in the ACS or CFf.
 4. Judgmentally selected two CFf and two ACS areas from which to select cases for review, based on the population of IAs.
 - C. Reviewed 113 judgmentally selected IAs over \$25,000 from the 4 offices in step I.B.4 to determine whether employees applied procedures and standards properly and consistently and obtained approvals if required (57 CFf and 56 ACS IAs). Due to the method the IRS used to maintain and close case files, we could not obtain a population from which to select a statistical sample. We were only able to select

¹ The ACS is a telephone contact system where telephone assistants collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

² The CFf is the unit in the area offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled returns.

³ The IDRS is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be Improved

from cases available in closed case inventory on specific dates. We selected IAs that were greater than \$25,000 because there was more risk involved in the higher dollar cases.

1. Determined whether the methods of verification of income and expenses were adequate. We determined whether national and local standards were consistently followed and, if not, whether there was proper documentation. We also determined whether estimated taxes were considered in determining the monthly payment amount.
 2. Determined whether the analyses of financial information obtained on Collection Information Statements were proper by independently using the IDRS and Choice Point⁴ to perform our own research on the taxpayers' assets, liabilities, and tax information.
 3. Determined whether managerial approvals were obtained, if required.
 4. Identified instances of noncompliance, inappropriate approval process, and/or inadequate verification of financial information.
- II. Determined if taxpayers with IAs who were required to file returns and pay estimated taxes remained in compliance.
- A. Obtained procedures for addressing taxpayers who do not remain in compliance with filing or payment requirements and obtained recent IRS Counsel opinions on this topic.
 - B. Reviewed a statistical sample of 67 IA cases and determined whether the taxpayers remained in compliance with filing and payment requirements throughout Calendar Years 2001 and 2002.
 1. From the population of 169,169 IAs in step I.B., identified 760 IAs that were granted between January 1, 2001, and December 31, 2001, where at least 1 tax period⁵ had a liability greater than \$25,000. These taxpayers may have had additional tax periods; however, based on the way we received the data, this was the most expeditious way to select the population and ensure our sample included balances due greater than \$25,000.
 2. Selected a sample of 67 IAs based on a 95 percent confidence level, a +/- 5 percent precision, and an expected error rate of 5 percent. We selected every 12th taxpayer on our list to ensure we covered the entire population.

⁴ Choice Point is a research tool used by IRS employees to research taxpayers' financial information.

⁵ A tax period for an individual is a calendar year for which a tax return is due.

**Procedures for Granting Installment Agreements
to Self-Employed Taxpayers Can Be improved**

3. Researched taxpayer information on the IDRS and verified IA payments, subsequent filings, and estimated tax payments. We determined whether the taxpayers stayed in compliance with filing and payment requirements.

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**Procedures for Granting Installment Agreements
to Self-Employed Taxpayers Can Be improved**

Appendix III

Report Distribution List

Commissioner N:C
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Office of Management Controls N:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division S

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be improved

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Actual; 47 taxpayer cases affected (see page 2).

Methodology Used to Measure the Reported Benefit:

We judgmentally selected 56 closed cases where the Automated Collection System function granted Installment Agreements (IA) to self-employed taxpayers. From this sample, we determined that 31 of the 56 cases did not have a proper financial analysis. Also, 41 of the 56 cases were not properly approved. Because a case could have had both conditions, the actual number of cases affected was 47 cases.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$713,000 (see page 4).

Methodology Used to Measure the Reported Benefit:

We judgmentally selected 113 closed cases where the Internal Revenue Service (IRS) granted IAs to self-employed taxpayers. From this sample, we determined that 87 taxpayers were still required to pay estimated taxes when the IA was granted. Of these 87, 37 (43 percent) taxpayers were not current with paying estimated taxes when the IA was granted. Assuming these taxpayers file a similar subsequent tax return where estimated taxes were required and they owe taxes when they file, this is the money that is potentially at risk.

Specifically, we determined that 10 taxpayers have already filed 2002 returns. For these taxpayers, there is currently approximately \$123,000 owed in taxes. We obtained the current module balance for these taxpayers. For the remaining 27 that have not yet filed 2002 returns, we obtained the most recently filed tax return (either 2001 or 2000) and determined the tax liability assessed (we used the transaction code 150 amount on the IRS' computer files). Because these taxpayers have not paid estimated taxes for 2002, we are assuming they will owe the full amount of any tax liability due. Based on that, we estimate that potential taxes due for these taxpayers if they do not pay with the return would be approximately another \$590,000.

**Procedures for Granting Installment Agreements
to Self-Employed Taxpayers Can Be Improved**

Appendix V

**Internal Revenue Manual Sections Related to
Estimated Tax Compliance When Granting
Installment Agreements**

The following are examples of sections of the Internal Revenue Manual (IRM) related to responsibilities of employees when granting an installment agreement (IA) if estimated taxes are involved. The IRM contains procedures that the Internal Revenue Service (IRS) uses. We paraphrased some of the sections to show the relevant information about estimated taxes.

IRM SECTIONS	DESCRIPTION
5.19.1.3.3.1 - Full Compliance Check	Establish whether the taxpayer has filed all returns for which he/she is liable and paid all types of tax, penalties, and interest. Among the items listed to consider are estimated tax deposits.
5.19.1.5.4 (1) - Can Pay Installment Agreement	Filing and paying compliance must be considered prior to determining that the best manner of paying delinquent taxes is through an IA.
5.19.1.5.4.9 (2) - Pending Installment Agreements	An IA should be identified as pending although the taxpayer did not pay estimated taxes while the employee waits for information from the taxpayer or does additional research.
5.19.1.5.4.10 - IA Rejection Criteria	An IA should be rejected if the taxpayer is not current in paying estimated tax payments for the current quarter and/or refuses to agree to make estimated tax payments during the IA period.
5.19.1.5.4.12 (3g) - Rejected Installment Agreements By Independent Reviewer	An IA should be rejected by the independent reviewer if the taxpayer is not current in paying estimated tax payments for the current quarter and/or refuses to agree to make estimated tax payments during the IA period.
5.19.1.5.4.22 (1) - Estimated Tax Payments –	IRC 6159 does not allow for an IA to be defaulted for non-payment of estimated tax.

**Procedures for Granting Installment Agreements
to Self-Employed Taxpayers Can Be improved**

Monitoring an Installment Agreement	IRS will continue to make estimated payments a condition for granting an agreement; however, IRS will no longer monitor and default an agreement for non-payment.
5.14.1.3 (5) Page 3 - Identifying Pending and Approved Installment Agreements on the Integrated Data Retrieval System (IDRS) ¹	Requests that meet certain criteria will be identified as pending IAs even if taxpayers are not in compliance with estimated payments requirements.
5.14.1.4.1 (13) - Compliance and Installment Agreements	Compliance with filing, paying estimated taxes and Federal tax deposits must be current <u>from</u> the date the IA begins.
5.14.1.2 (9e) - Installment Agreements and Taxpayer Rights	Inform taxpayers that current returns for taxes must be filed and current deposits (or estimated taxes) must be paid to qualify for an agreement.
5.14.9.3 Table 9.3-1 - Independent Administrative Review	Taxpayers must be in compliance with paying current estimated taxes.

¹ The IDRS is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be improved

Appendix VI

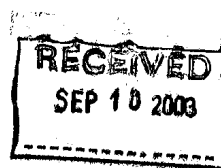
Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SEP 8 2003



MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Dale F. Hart *Dale Hart by M. Sullivan*
Commissioner Small Business/Self-Employed

SUBJECT: Draft Audit Report – Procedures for Granting Installment
Agreements of Self-Employed Taxpayers Can Be Improved
(Audit # 200230040)

I reviewed your report and agree with the recommendations. Decisions for granting installment agreements (IA) to self-employed taxpayers are more complex than those for taxpayers who are not self-employed. I was pleased to see that our field employees adequately analyzed the financial information and came to the correct determination when granting IA's. We will continue to stress the importance of financial analysis to all our employees.

As you stated in your report, self-employed taxpayers are usually required to make periodic estimated tax payments because they do not have withholding on their income. We agree that our self-employed taxpayers should continue to make estimated tax payments on their potential subsequent tax liabilities. We currently inform all taxpayers seeking an IA that they must remain in compliance with the tax laws before we establish an IA. However, once we grant the IA, it can not be defaulted solely based on noncompliance with estimated tax payments. Until the taxpayer files a return there is no way of knowing whether the taxpayer has a tax liability for any given period. If the taxpayer later files a return and additional tax liabilities are assessed, then the taxpayer would be in default on the IA since they did not meet the requirements to stay current with all tax liabilities.

We do not agree with the Outcome Measures found in Appendix IV of your report regarding the impact that the recommendations will have on tax administration. The outcome measure indicates that we could use the taxpayer's liability from the prior year to predict tax liabilities for the following year. The report states the IRS could potentially receive \$713,000 in increased revenue. Until the taxpayers file their returns, there is no way to determine just how much revenue the Service would actually receive. A prior year's liability is not a conclusive predictor of current year income or ultimate tax liability. The estimated amount of liability may not have materialized in 2002 because self-employed taxpayer incomes can and do fluctuate.

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be improved

2

In addition, of the 37 cases reviewed for self-employed tax liabilities, you determined 10 cases owed taxes of \$123,000. Using information from prior years and using the total tax, you assumed an additional \$590,000 in outstanding taxes for another 27 cases. Unless the returns are reviewed it cannot be determined if the total tax consists of self-employed income only. Therefore, we cannot agree with the potential increase of \$713,000.

Our comments on your recommendations follow.

RECOMMENDATION 1

The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, who is responsible for implementing policies for the Collection function, should consider implementing a systemic control in Automated Collection System (ACS) that would automatically route an IA case over \$25,000 to a manager for approval.

CORRECTIVE ACTION

We will prepare a Request for Services, through the Office of Compliance Center Collection, to implement a systemic control in ACS to route all IA cases over \$25,000 to a manager for approval.

IMPLEMENTATION DATE

Submission of RIS – January 15, 2004.

Implementation – January 15, 2006 - We will reschedule the implementation date once the RIS is accepted by Modernization & Information Technology Services (MITS). If the RIS is not accepted, we will close the corrective action.

RESPONSIBLE OFFICIAL(S)

Director, Filing Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Office of Compliance Center Collection, will advise the Director, Filing Compliance of any corrective action delays.

RECOMMENDATION 2

The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, who is responsible for implementing policies for the Collection function should reemphasize procedures to employees and managers regarding substantiation required for financial analysis and criteria for streamlined agreements.

CORRECTIVE ACTION

We will issue a memorandum of instructions to employees and managers reminding them of the substantiation required for financial analysis and the criteria for streamlined agreements. Managers will also be instructed to cover financial analysis in group meetings.

IMPLEMENTATION DATE

January 15, 2004

Procedures for Granting Installment Agreements to Self-Employed Taxpayers Can Be improved

3

RESPONSIBLE OFFICIAL(S)

Director, Filing Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Office of Compliance Center Collection, will advise the Director, Filing Compliance, of corrective action delays.

RECOMMENDATION 3

The Director, Compliance, SB/SE Division, should ensure IRS procedures are consistent for granting IAs where estimated taxes are involved and reevaluate those procedures for certain situations to require that taxpayers be current with the payment of all estimated taxes when an IA is granted.

CORRECTIVE ACTION

We will amend Internal Revenue Manuals (IRMs) 5.14 and 5.19 to ensure consistency in the procedures for granting an IA. We will reevaluate IA procedures for opportunities to further encourage compliance with the payment of all estimated taxes when an IA is granted. An interim guidance memorandum will be issued to the field explaining the changes by December 31, 2003. We reemphasize that we do not agree with outcome measure that potentially \$713,000 in revenue would be lost due to unpaid estimated tax payments.

IMPLEMENTATION DATE

Interim Guidance memo – December 31, 2003

Changes submitted – August 15, 2004

IRM published – November 15, 2004

RESPONSIBLE OFFICIAL(S)

Director, Payment Compliance, Small Business/Self-Employed Division

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Office of Case Resolution Alternatives, will advise the Director, Payment Compliance, of corrective action delays.

If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division at (202) 283-2200.